DR. KURT RICHEBÄCHER

Muehlegasse 33
CH-8001 Zuerich
Switzerland

CURRENCIES AND CREDIT MARKETS

No.200/ December, 1989

Certainly a credit inflation as such is a thousand times better than a credit deflation; but the decisive point - not emphasized enough by Keynes - is that a credit deflation follows a credit inflation just as surely as a hangover a drinking orgy. This is crucial, and takes away the foundation from that subtle form of inflationism represented by Keynes.

Wilhelm Roepke, Keynesianimus III

HIGHLIGHTS

The recent circumstances in Europe are truly enormous in portent and could emerge as the single most important factor shaping the international economies and capital markets of the 1990s.

Assuming everything else proceeds smoothly, the only thing that stands in the way of a potential torrent of capital investment in Eastern Europe is a major redirection of European capital exports (being primarily of West German origin). And that can only happen at the expense of demand for American, Canadian and Australian bonds.

It is not accidental that all of the countries with large external deficits have also had rampant asset price inflation. News that real estate prices have begun to weaken in the deficit countries adds a complicating dilemma to domestic monetary policies.

The stark reality is that U.S. fiscal and monetary policies have little manoeuvrability in combatting an economic downturn. Fiscal policy is paralysed by the existence of a huge budget deficit, and monetary policy is virtually immobilised now that interest rate differentials vis-a-vis the D-Mark have completely collapsed.

In the case of Japan, there has been too much talk and too little action against inflation. The Bank of Japan has lost its credibility. That's a classical way to weaken a currency. In our opinion, the yen's softness has been deliberately engineered.

The inflationary implications of a stronger German economy are much less than feared. Longer-running inflation determinants are embedded in a high national savings rate, capital formation and productivity growth. All these "inflation fundamentals" have improved dramatically in Germany during the 1980s and continue to do so.

The simple reality is that exchange rates have again started moving in line with their true underlying economic fundamentals. No longer are currency markets singularly driven by interest rate differentials.

The growing disarray in the U.S. real estate market will, over time, hit the U.S. economy with tremendous force. Both the Fed and the government won't be able to stave off the inevitable disaster. Past excesses have simply been too great.

Our view is that the risks in the U.S. dollar are rising rapidly and that the worst part of a decline is still ahead.

(Editors Note: This letter is a landmark issue in a sense...it's our 200th. As our world-wide readers know, this international letter has long been written from the European continent. We assure our readers that the heavy focus on Continental Europe recently (and in particular West Germany, the largest European economy) has little to do with our geographical proximity. Quite simply, the recent circumstances in Europe are truly enormous in portent and clearly emerge as the single most important international factor shaping the 1990s.)

THE 1990S: EUROPE AT RINGSIDE

It took a little while, but markets have finally awakened to the reality that the opening of East Germany is no reason to pity West Germany. Even though there may be the potential bony problem of financial burdens and inflationary pressures the goose is still worth eating. On the contrary, the world may even have come to envy West Germany among others for its ringside seat to the gargantuan possibilities that the economic integration of Eastern Europe implies.

As it was, the campaign to forge a true common market between the twelve members of the European Community by the end of 1992 was already boosting capital spending and economic growth rates into overdrive. Now, the opening of Eastern Europe could prove even more important than the drive for a single market. Clearly, Western Europe has the most to gain from this development and West Germany seems situated to play the key role. The assurance of that role is not one of simple geographical proximity. What qualifies West Germany's for that task is its vast arsenal of excess domestic savings.

Picking Penurious Partners. The way we see it, recent events make for a splendid division of international labour: Japan uses its excess savings to finance the U.S. trade deficit (thus financing a major contributor to its exports surplus) and Germany employs its surplus to finance the rebuilding of Eastern Europe.

TRADING FOR THE SPOILS: HAMBURGERS OR CAPITAL?

As the spectre of Eastern European lucre salivates the tongues of Western industry, it's interesting to note the differences of approach and style. North Americans are quick to seize the notion of vast pent-up demand for consumer goods and services. Prospects for enhanced trade with Eastern Europe are framed in the idea that "the consumer comes first". To quote Bear Stearns' view of the foreseen opportunities: "*And after McDonald's and Coca-Cola, why not Phillip Morris?*" Then, typical of this Wall Street theme, they draw the conclusion: "*There are a large number of other American consumer companies with strong franchises in Europe.*"

Engine Before the Caboose. To be sure, Continental Europeans are thinking along a completely different wavelength. To begin with, they model a completely opposite set of priorities. New investment must come first... in other words, the egg-laying hen should precede the McDonald's Egg McMuffin. More importantly, heavy investment into productive facilities are required to create the wages and incomes that can then afford to buy consumer goods. Consumption is limited by production and not vice versa.

HOW MUCH WILL IT COST AND WHO CAN AFFORD THE PRICE?

What Eastern Europe needs most is capital and lots of it. If the eastern bloc is to catch up with the West in the next ten years, the cost of new productive investments will run into the hundreds of billions of dollars.

To gauge the enormity of the capital requirement let's isolate the example of the two Germanies. East Germany employs 3 million workers. In West Germany, capital stock per industrial worker amounts to about DM 200,000. To raise productivity in East Germany to West German levels would require new investment of at least DM 100,000 (per-capita). That makes for a capital project of a potential DM 300 billion -- a breathtaking amount.

Spread over ten years, however, a capital requirement of DM 30 billion annually becomes

quite manageable for West Germany. That figure compares feasibly with a savings surplus of more than DM 100 billion per annum presently. The vital point is that West Germany has both the financial capability and the capital goods to rebuild Eastern Europe. Given the immensity of these capital needs it also becomes obvious that government hand-outs so far are nothing more than a few drops in the bucket.

A Truly Monumental Opportunity. Provided that the necessary political and economic reforms take place soon, German capital could flood into East Germany the quickest. The country is practically a virgin market, both in terms of the supply and the demand sides of its economy. That combination offers the salivating prospect of investing into a rapidly expanding home market. A businessman couldn't wish for a better break. Such an opportunity hardly exists anywhere else in the world. To us, it assures a strong European (and German) economy "as far as the eye can see".

Assuming everything else proceeds smoothly, the only thing that stands in the way of a potential torrent of capital investment in Eastern Europe is a major redirection of European capital exports (which is primarily of West German origin). An investment boom in the East will likely only happen at the expense of American, Canadian and Australian bonds.

We agree with the statement of the late Alfred Herrhausen (the recently assassinated Chairman of the Deutsche Bank): "Given the necessary reforms, East German living standards could match those in the West in only five to ten years."

THE WEST GERMAN ECONOMY CONTINUES STRONG

West Germany's economy continued to gain strength in the third quarter. Year-over-year, real GNP surged by 4.2% (taken through the first nine months of 1989) and was fuelled by a combined export and investment boom. Both components expanded at a 10% clip -- the fasted rate since the late 1970s. In striking contrast, private consumption rose a modest 1.5% while public spending even decreased 0.5% (all in real terms). Actually, the consumption sector, both private and public, accounted for no more than 21% of overall real GNP growth in 1989.

That's the kind of growth mix policy-makers all around the world would covet. It goes without saying that the weakness of consumer and government spending - due to stringent fiscal policy and stubborn German saving habits - played a key role in containing inflation against a backdrop of booming exports and investment.

THE WEST GERMAN INFLATION QUESTION

German Inflation Versus U.S. Disinflation? A lot of gloom and doom has been spread recently about Germany's ascending inflation rate, already running at 3.2% and is still widely seen to be rising. In many reports, accelerating German inflation is contrasted unfavourably with the decelerating inflation (if not disinflation and even deflation) in the United States.

For many Wall Street economists, the word "disinflation" conjures up images of a healthy economy that holds the promise of all kinds of delights: a strong dollar and a bull market in U.S. bonds and stocks that will lure legions of foreign investors.

But, let's get back to reality. True, the U.S./German inflation differential has narrowed to a low not seen since the 1960s. However, such a superficial comparison makes for a grossly flawed conclusion. The two inflation rates, after all, have come about under radically different economic conditions, both internally and externally. The fact that everything is booming in West Germany while the economy is slowing in the United States is bound to narrow the differential...and for very positive reasons.

Germany's inflation rate, moreover, has been heavily swollen by two extra-ordinary factors: significant increases in indirect taxes and the adverse impact of a strong dollar on German import prices. Taking both of these one-time factors into account, Germany's "core" inflation

rate appears to have remained at its long-term trend of about 2%. That compares very favourably to an American "core" inflation rate of 4-5%. And, let's not forget that Germany's lower inflation rate still facilitates a profit boom while a serious profit squeeze afflicts the U.S..

Germany: Demand and Cost Push Pressures. However, without a doubt, there are some inflation pressures to contend with. The stage is set for both a demand and a cost push in Germany next year. The demand push will come from three sides: a drastic income tax cut amounting to about DM 24 billion, from sizable wage hikes, and from the large inflow of immigrants from the East. Together, these three influences will certainly lead to a spurt in consumer spending and residential construction. The threat is that this probable demand push will become linked with a cost push. For example, a giant metal workers union has lodged a claim for a 9% wage rise and a two hour cut in the work week to 35 hours in forthcoming pay negotiations.

Meanwhile, a mass migration into West Germany is reaching staggering dimensions. Counting newcomers from East Germany, the Soviet Union and other parts of Eastern Europe, immigration this year will exceed 700,000, well over 1% of the West German population. Sharply higher demand for housing is therefore very likely and will probably add to inflation pressures.

Taking all these points into consideration, it's become a foregone conclusion for many market analysts that accelerating inflation in Germany - already at 3.2% - is a sure precursor to long-term weakness of the D-Mark against the dollar. The dollar, on the other hand, supposedly will be supported by decelerating inflation. From this viewpoint, the drastic shrinkage of the U.S./German interest rate differential is largely seen as irrelevant for the currency markets. Apparently, it is expected that the currency markets will primarily reflect narrowing inflation differentials.

Inflation More Than a Monetary Phenomenon. Apart from the factors we cited above, we nonetheless think that the inflationary implications of a stronger German economy are much less than feared. There doesn't appear to be anything in sight that would point to deterioration in long-running inflation fundamentals. Germany's low inflation bias - in contrast to Americas high bias - originates from considerably deeper causes than just differences in monetary policy. The primary inflation determinants are embedded in a high national savings rate, capital formation and productivity growth. All these "inflation fundamentals" have improved dramatically in Germany during the 1980s and continue to do so.

Worries Overdone. Next, let's take a look at short-term inflation trends. In January of 1990, Germany's inflation rate will suddenly look much better and can be expected to dip well below 3% as the effects of last year's early-year spurt will drop out of year-over-year comparisons. Even more surprising is the fact that nobody ever mentions the strong anti-inflation effects of the recent sharp dollar drop. These effects are formidable since international commodities are priced in U.S. dollars. That works to Germany's favour since at least 30% of its total imports are priced in dollars (while only 6.6% of imports are from the United States). Therefore, changes in the dollar's exchange rate can have disproportionate effects on the price levels of other countries - exaggerating the negative when the dollar rises and overstating the positive when it falls. Last April, German import prices were up 7.3% against a year ago. Now, the same rate is already down to 3%.

A strong D-Mark will significantly add to the German trade surplus by improving the terms of trade - the famous J-curve effect - as imports cheapen relative to exports. Ultimately, lower-than-expected inflation will favourably impact long-term interest rates. Once sentiment swings sharply against the dollar, German and European hard-currency bond markets can be expected to fully "decouple" from U.S. rates.

This brings us to another important point that is generally ignored. All these beneficial effects of a declining dollar - on costs, prices and trade balances - will not be confined to

just Germany. These gains will accrue in the same way to all countries in the DM-bloc - in other words, all of Europe. Lower inflation and long-term interest rates, in turn, should be supportive of relatively strong economic growth in Europe.

WHITHER THE DOLLAR? THE FIVE PILLARS OF "DOLLAR OPTIMISM"

So far the dollar has fallen 14% from its peak of DM 2.0475 on June 15th. We don't need to mention that most forecasts were bullish at that time and foresaw further advances to DM 2.20, if not DM 2.40. Yet, despite the recent dollar drop, most commentators still keep talking about a dollar bull market.

Each new fall is followed by the soothing comment that the final dollar-bottom has arrived and that the dollar could now be expected to stay in a narrow trading range. Typically, the focus is more on the question of when the dollar will rebound rather than how deep the dollar may yet fall. Another symptom of an underlying positive sentiment is the absence of a big rush into German bonds by foreign investors. DM-bonds - the normal vehicle for currency speculation - have seen limited interest even though the yield advantage of U.S. bonds has virtually disappeared.

Why is "dollar bullishness" so stubborn and persistent? There seems to be quite an array of perceptions and theories, both old and new, that continues to foster such psychological resilience. Let's quickly review a supporting cast of five of these.

The Yen Makes Good Company. It is probably most notable that the dollar has held up well against the Japanese yen. Popular opinion is that the yen is the strongest and most important currency next to the dollar and certainly far more important than the D-Mark. Therefore the logic that follows is simple and plausible: If the dollar stays even or appreciates against the yen, it can't really be categorized as weak. From that perspective, the dollar's decline against the D-Mark must be just an isolated "D-Mark phenomenon" that is bound to be temporary.

Greenspan: A Legend in His Own Time. In our opinion, a second major pillar still supporting the dollar is the firm faith placed in Mr. Greenspan and the Fed... or put more precisely, over-confidence in the Fed's ability to engineer the famous "soft landing". Even though economic data has become considerably weaker than expected, this evidence is brushed aside with the argument that the Fed will do whatever is needed to avoid a recession. Most analysts and investors remain convinced that interest rates will, if necessary, fall fast enough to stimulate the economy before it falls into the grips of a recession.

Soft-Landing Benefits. A third source of dollar optimism is the hope that an economic slowdown will bring about lower U.S. trade deficits, while at the same time decreasing inflation and interest rates. The prospect of a new bull market in bonds and stocks is seen to be supportive of the dollar.

A Revival of the PPP. A fourth support for dollar optimism seems to stem from the timely rediscovery and newfound popularity of the purchasing power parity theory (PPP). This doctrine has had its ups and downs since Word War I. Nonetheless, it claims that exchange rates over the long-term are determined by relative national price levels. On that basis, OECD economists have declared that the U.S. dollar is the most undervalued major currency, trading some 20-30% below purchasing power parity against the yen and D-Mark.

Above the Laws of Economics. Last, but not least, there seems to be a widespread notion that the U.S. dollar is not subject to the same rules as other currencies because of the outstanding size of its economy and the dollars role as the world's reserve currency.

We don't subscribe to this "special case" theory in the slightest. History has already clearly disproved it during the 1960s and 1970s when one dollar crisis followed another. It may seem that the dollar has since become immune to a persistent trade deficit, but in this respect it is also true that dollar-strength has not been exceptional. During the last two years,

currency exchange markets have generally been governed by nominal interest rate differentials, whereas most other fundamental considerations in valuing currencies were completely ignored.

TRENDS WEATHERING THE DOLLAR

Our view is that the risks in the U.S. dollar are rising rapidly and that the worst part of its decline is yet ahead.

Interest Rates Are No Longer a Buffer. We think that the heightening risks for the U.S. economy and the dollar stem from two main sources. Firstly, economic data portrays a progressively weakening economy which in normal circumstances would justify an easier monetary policy. Unfortunately, the stark reality is that fiscal and monetary policies have little manoeuvrability in combatting an economic downturn. Fiscal policy is paralysed by the existence of a huge budget deficit, and monetary policy is virtually immobilised now that interest rate differentials vis-a-vis the D-Mark, have completely collapsed. Any further reduction in the Fed funds rate risks a sharp dollar fall.

The differential on three-month Euro-deposits has shrunk to a narrow 20-30 basis points in favour of the dollar compared to 375 basis points as recently as last April. Fear of letting U.S. short-term interest rates fall below those of Germany is the most obvious explanation for the Fed's hesitancy to allow the next downward move in its funds rate.

A Growing Alternative. Is the D-Mark really that important for U.S. monetary policy? Yes, and in fact more than that, we think the D-Mark may even be the most important element. Despite the increasing importance of the yen, the $\DM rate represents the key axis around which world currency markets revolve. Japan clearly has greater financial power than Germany, yet the polar power to the U.S. dollar in the international monetary system is the D-Mark and not the yen.

This development is attributable to the fact that the D-Mark has steadily increased its international functions, both between central banks and investors. It is the undisputed (though undeclared) key currency of Continental Europe. Many central banks, even outside Europe, hold part of their international reserves in D-Mark. Similarly, the D-Mark (and the currencies of the D-Mark bloc in general) are seen as the main alternative to the U.S. dollar.

Importantly, there is a second difference between the D-Mark and the yen: the relative share of world trade. Only 7% of total European exports go to the United States. In contrast, the share of Japanese exports funnelled to the United States has risen dramatically from 20% in 1975 to 34% in 1989.

Having presented all this background material may we re-emphasize three main conclusions: First, it would be a great mistake to dismiss the weakness of the dollar against the D-Mark as something of only passing importance; second, since the direct trade influences on the $/DM exchange rate are very weak, this relationship can swing widely under the force of changing investment demand. And, for that same reason, it is also true that PPP only has a weak influence on the $/DM relationship.

Third, (precisely for the above reasons) the Fed must be frightened to let dollar-based interest-rates fall below DM interest rates. Any such move would risk a sudden slide of the dollar with devastating consequences for Wall Street. Unfortunately though, as the U.S. economy continues to sink (as we assume), the Fed will be forced to ease further and at great risk to the dollar.

A RESHUFFLING OF SURPLUSES

Over the past two years, both the media and the financial markets have been so preoccupied with what happens in the United States that important changes on the part of Germany and Japan have gone largely unnoticed. One of the most important aspects has been the trend

in the current balance of payments.

The figures in Table 1 draw a picture which differs from prevailing perceptions. First of all, it may seem that an improving trend in the U.S. current-account deficit has picked up momentum in the third quarter. We must point out that that is entirely the product of an statistical illusion. In the first place, the trade deficit deteriorated slightly, falling from $27.55 to $27.75 billion. The stark reality is that the whole improvement came from the decline in the value of the dollar against the D-mark. That occurrence pushed up the value of assets and income in Europe. Capital gains and higher dollar income are treated as reductions in the current account.

The second outstanding feature is the rapid deterioration in the Japanese trade balance. The trouble is that very little of that decline has been to the benefit of the United States. A third astonishing feature is that West Germany is on the verge of outperforming Japan in its external surplus.

Two years ago, in 1987, the current-account surpluses of Japan and West Germany were $87 billion and $45 billion, respectively. This year, the surpluses should draw even at about $60 billion. Next year, we would not be surprised to see a German surplus of well over $70 billion - largely due to the falling dollar - and a Japanese surplus of only $40-50 billion.

CURRENT ACCOUNT DEVELOPMENTS

		GERMANY[1]	UNITED STATES[2]	JAPAN[3]
1988	Jan-March	16.6	-32.0	23.1
	April-June	25.3	-33.5	16.8
	July-Sept.	23.0	-32.3	18.1
	Oct.-Dec.	20.1	-28.7	20.8
1989	Jan-March	30.2	-30.4	21.5
	April-June	26.4	-32.1	12.8
	July-Sept.	27.8	-22.7	13.1

All figures seasonally adjusted. 1. in DM, billions 2.& 3. in $, billions.

MADE IN JAPAN: YEN WEAKNESS

In Japan, industry is working at exceptionally high levels of capacity utilization. Labour shortages are spreading. The wider money supply is expanding at almost 10%. Asset price inflation - particularly afflicting land and stock prices - is rampant. Machinery orders are up some 20% against year-ago levels. All in all, the economy is clearly more overheated than that of Germany. Given these boom conditions, it is plainly obvious that Japanese interest rates are ridiculously low at a discount rate of 3.75%. There are plenty of overwhelming reasons why the Japanese central bank should tighten further.

There has been too much talk and too little action against inflation. Quite simply, the Bank of Japan has lost its credibility. That's a classical way to weaken a currency. Despite its unfailing rhetoric against inflation and the weak yen, the Bank of Japan clings to an extremely expansive monetary policy - one that is the most expansive among the major countries by far.

One thing we are absolutely certain of: If the Japanese authorities really wanted a stronger yen, they could have it tomorrow by simply stepping on the monetary brakes. Their booming economy, laced with growing inflationary pressures and the weakness of their currency, urge it upon them. In fact the case is so compelling, it is our opinion that the yen's softness is deliberately engineered by the Japanese central bank.

Reasons For the Weakness? It would be very interesting to know why the Japanese authorities are keeping their monetary policy looser than justified. Is it for internal or external reasons? Does the Japanese government doubt the robustness of their own economy? Are they afraid of pricking the inflation bubble in the domestic asset prices of stocks and property? Or, are they more afraid that an aggressive monetary tightening on their part would knock out Wall Street and the dollar by trimming Japanese capital outflows. They may anticipate that such a sequence of events would have devastating consequences for Japanese investors and U.S. exports. All of these are plausible reasons.

More Than a "D-Mark Phenomenon". These and other considerations would certainly take Japanese monetary policy hostage. If our speculations have any basis, it means that markets are taking a false comfort from the fact that the dollar has been holding its ground against the yen. The dollar is being compared to a currency that has its own reasons for weakness. All the weak currencies - dollar, yen, pound, etc. - have their own special problems.

The simple reality is that exchange rates have again started moving in line with their true underlying economic fundamentals. No longer are currency markets singularly driven by interest rate differentials.

An important point to recognize is that the weakness of the dollar and the yen have fundamentally different origins. The yen's weakness is traceable to monetary causes and may therefore only be a temporary phenomenon. By contrast, the dollar's weakness is a function of deep structural problems that may have long-term implications.

THE JAPANESE CAPITAL SPENDING BOOM VERSUS THE U.S. BORROWING BINGE

Experience and theory say that the most important influences on currency movements over the short-term are relative monetary conditions. The key to the dollar rally until mid-1989 was the Federal Reserve's tightening relative to the monetary stance of both Germany and Japan. Furthermore, the popular perception of the U.S. economy in early 1989 was one of rapid economic growth, an improving trade balance, and rising inflation in the face of a non-accommodating central bank.

Over the long term, however, a currency's strength or weakness is determined by more fundamental forces. The most important of these is the rate of capital accumulation, particularly as measured by the relative growth rates of manufacturing capacity. That has been our long-held view, and is one that we have emphasized repeatedly in direct contradiction to the purchasing power theory that still remains the cornerstone of dollar bullishness.

What counts in a dynamic world economy is not how cheap a country's products are, but what it can produce and deliver at internationally competitive prices. Where there is strong investment there is also likely to be price competitiveness. If that were not so, business would not have the motive to invest.

Japan is on a capital spending binge that is sure to boost its trade surplus over the long haul. Super-efficient producers are rushing to expand capacity, modernize plants and to develop new products. America's situation, by contrast, emerges from a borrowing binge that has financed overconsumption and internal asset price inflation at the expense of productive investment. Long-term trade improvement can only be built on the strength of accelerated capital accumulation. In this respect, however, the U.S. economy is far from catching up with Japan and Germany. The U.S. is rapidly falling behind.

THREE CRITICAL FACTORS FOR THE DOLLAR

The crucial questions - for Wall Street and the currency markets - is whether the current economic slowdown will end in the elusive soft landing, or a recession and if the latter, how severe will it be?

To us, the general complacency on these questions are simply incomprehensible. We see three conditions that are extremely critical in framing any forecast.

First, long years of pervasive, non-stop over-borrowing and over-spending have unbalanced, distorted and leveraged the U.S. economy as never before. Given such unprecedented excesses in credit and debt, a return to normality is simply not possible without very painful withdrawal symptoms, both in the real economy and in the financial markets.

Second, over-leveraged borrowers also have their problematic counterparts in the financial system. Thrifts, many banks and the junk bond market are in deep trouble with souring loans and investments looming into the hundreds of billions of dollars.

Third, it becomes increasingly apparent that the Fed is caught in an unprecedented conflict between two policy requirements. From the perspective of a faltering economy and the inherent risks of over-leveraged balance sheets, the Fed clearly should be easing. However, worries over inflation and the dollar oblige the Fed to hold interest rates too high for the comfort of a weakening domestic economy. Needless to say, this predicament raises the risk of an economic downturn.

With all these worrisome factors in mind, the general complacency about the Fed's fine-tuning capabilities is a mystery. Are there any hard facts that might justify this faith in the Fed from this point forward? We would say there are virtually none given the spectre of current trends. Trade and capital spending, the engines of growth over the past two or three years, are sputtering. Exports have flattened out and net exports are falling. The dismal prospects for capital spending are evident in nose-diving new orders and diving corporate earnings. Non-defense capital goods orders, apart from the aircraft industry, plunged 18% in the third quarter.

Consumer spending is the only possible expansionary influence on the economy in the near future. Many economists are relying on continued strength in the service sector to provide the necessary income growth. In the meantime, employment in the service sector is slowing. Even if it were to happen, such a mix of weak exports and investment and strong consumption would be utterly undesirable.

THE SOFT LANDING: HAS IT ENDED?

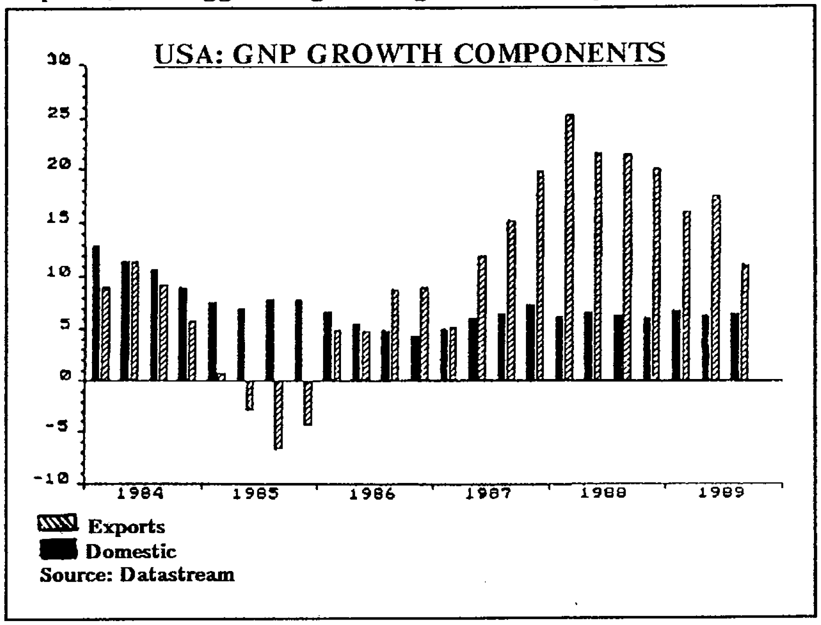
We cannot overlook the fact that market sentiment still remains rather optimistic on the U.S. economy and the dollar. While outright bullishness may be somewhat restrained now, it is true that very few seem to be able to envision any down-side whatsoever. Consumer confidence, as measured by the University of Michigan and the Conference Board, is still as high as it has been in about 20 years. We can only conclude that Wall Street is not alone in giving Mr. Greenspan a great deal of credit in managing to slow the economy into a "soft landing".

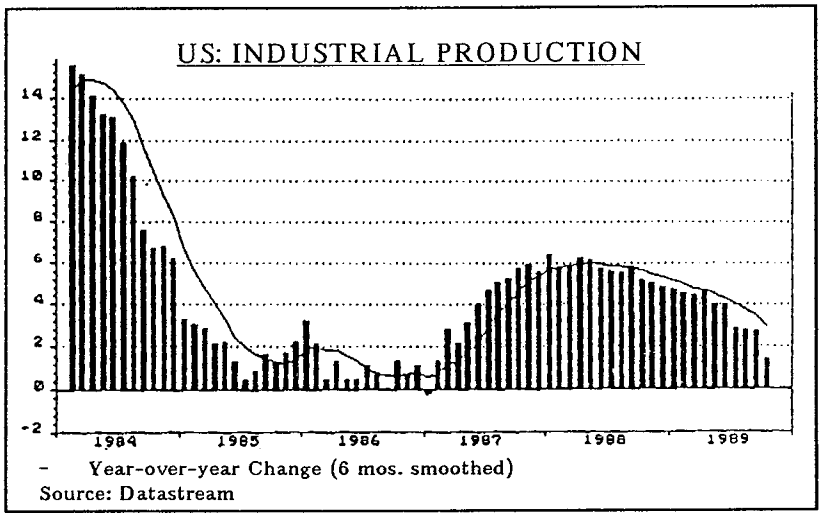
No doubt, Mr. Greenspan deserves some praise. Nevertheless, we must remember that it wasn't his fine-tuning skills that rescued the U.S. economy from recession over the past 2-3 years. While the Fed aggressively tightened, exports - propelled by a prior massive dollar devaluation and vigorous demand growth abroad - took up the lead and compensated for depressed domestic demand.

The charts on the next pages illustrate the main aspects of economic developments since 1984. We draw particular attention to the upper chart which shows the composition of GNP growth divided between domestic demand and exports.

We strongly suspect that the unique experience of an export-led recovery has misled many observers into over-estimating the effectiveness of fine-tuned monetary policy and to under-estimate the degree of monetary tightness. As the export boom peters out, the drastic slowdown in credit and money growth will now more fully impact the domestic economy. That points to the critical difference between 1987 and 1990, and it could well be that we

Exports, the biggest engine of growth now sputtering.





are now witnessing, not the beginning, but the end of the "soft landing".

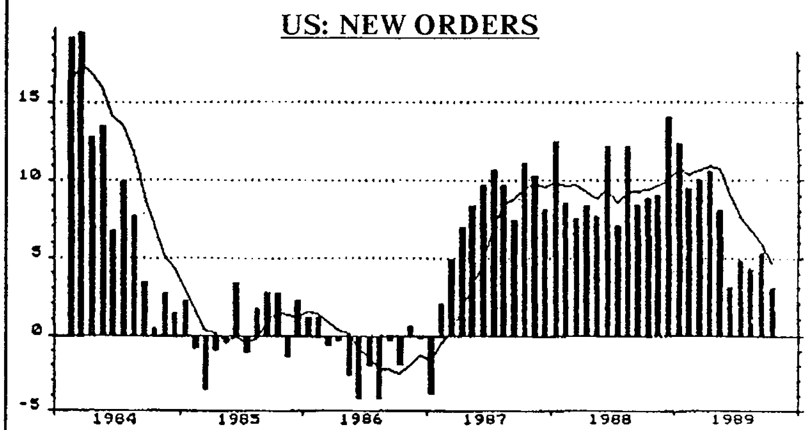
THE EFFECTS OF CREDIT INFLATION REVISITED

As our last letter showed, credit growth in the United States has been almost cut in half, falling from a level of 13-14% in 1984-86 to 7-8% recently. We said that credit provides the best information as to what is happening in an economy. People who borrow, spend it. They may buy currently produced goods and services or they may buy physical assets that have been produced (houses for example). As consumers do so, GNP and price inflation (as measured in the ordinary price indexes) go up.

Part of any excess money creation may be shipped abroad through the trade account or some may flow over into existing assets markets (i.e. real estate, factories and paper assets including stock, bonds, mortgages...etc.) Additionally, it is important to recognize, that the monies that leak out of the trade deficit tend to return in the form of augmented foreign demand for real assets. This effect on existing real assets lies entirely outside of GNP tabulations. As such, prices of existing assets rise (asset price inflation).

INFLATION HAS ONLY THREE OUTLETS

We have repeatedly stressed that the recent financial excesses in a number of countries - measured in terms of credit expansion - are more extreme than they were in the inflationary 1970s. In contrast to past inflations which were always centred in an over-expansion of credit for investment purposes (mainly inventories and real estate) the present "new" inflation has been far more complex and dispersed. Abundant money was borrowed to buy paper assets or existing real assets - the prices of which were rising rapidly. The faster asset prices rose, the more people wanted to buy them. It's been a delightful inflation that has made people feel wealthier seemingly without effort. Feeling wealthier, individuals saved less and borrowed still more, producing the roaring consumer boom. As a consequence, resulting high interest rates and exchange rates served to crowd out manufacturing.



- Year-over-year change (6-mos smoothed)
Source: Datastream

THE LURKING THREAT OF ASSET PRICE DELATION

It is not accidental that all of the countries with large external deficits also have rampant asset price inflation in common. Foremost among these countries we would include the United States, Britain, Canada and Australia. Persistent trade deficits and asset inflation are the symptoms of one and the same cause: credit excesses.

If the central banks would have worried about asset price inflation as much as they worried about retail price inflation, the consumer boom would not have careened out of control. The decisive point - as the quotation on first page says - is that a "credit deflation" follows a credit inflation as surely as a hangover a drinking orgy". On that theory we have long anticipated the news that real estate prices in the deficit countries have begun to weaken. Now, all of a sudden, one can read almost daily about plunging commercial property and housing prices. Obviously, the real estate slump is spreading as is evident in the United States.

Source: Datastream

Don't think that the weakness in real estate prices is just a temporary softness that will evaporate with easier money. Most observers still cling to that comforting view. To quote the Wall Street Journal on the subject: *"The Federal Reserve - in fact, the whole U.S. government - won't stand by and do nothing."* Again and again this incredible faith in the omnipotence of governments comes to the forefront.

Our answer is very different. The very people and institutions who supposedly are able to solve the problem have created it in the first place by their own mismanagement of the economy. To strengthen the entire real estate market is at least a hundred times more difficult than perking up a stock market. A little easing would not do in any case. What would be required is a veritable flood of new money. And that won't be forthcoming because the Fed's hands are tied.

CONCLUSIONS

In our view, the growing disarray in the U.S. real estate market will, over time, hit the U.S. economy with tremendous force. Both the Fed and the government won't be able to stave off the inevitable disaster. Past excesses have simply been too great.

It seems, we cannot draw attention to this point often enough: Despite the reassuring claims that the U.S. economy is healthy and that the Fed has everything under control, in reality, the economy is more vulnerable than ever before.

Simultaneously, monetary and fiscal policy has little or no room to manoeuvre should they wish to avoid the dollar's steep fall.

The most critical phase for the economy, the banking system, the dollar, and the financial markets begins when debts collide with falling earnings and collapsing collateral values. It might happen soon, yet everybody is unprepared.

A simple recession without any major consequences is a virtual impossibility for the United States. And that goes for all the other countries with similarly gross imbalances in their internal and external economic structures.

Our view is that the risks in the U.S. dollar are rising rapidly and that the worst part of the decline is still ahead.

Publisher: Dr. Kurt Richebächer
Muehlegasse 33, CH-8001 Zuerich, Switzerland
Editor: Hahn Capital Partners

Annual Subscription:
SFr. 600.–/US-Dollar 400.– for subscribers outside Europe.

Languages: German/English